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Person To Contact:

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Date:

January 28, 2011

Legend

Date 1 =

Settlor =

Trust =

Date 2 =

Date 3 =

Spouse =

A =

B =

Grandchild 1 =

Grandchild 2 =

Grandchild 3 =

Date 4 =

Child =

Date 5 =

Y =

Individual =

Bank =

State =

State Law 1 =

Citation 1 =

Citation 2 =

State Law 2 =

State Law 3 =
State Law 4 =
State Law 5 =
Year 1 =
Year 2 =
Date 6 =
Date 7 =
Court =

Dear _____ :

This letter responds to your letter of January 27, 2011, and prior correspondence, in which you request rulings concerning the federal gift and generation-skipping transfer tax consequences of a court-approved settlement agreement among the parties of a trust.

On Date 1, Settlor created Trust, a revocable living trust, and further amended it on Date 2. Settlor died on Date 3, at which time Trust became irrevocable. Date 3 is prior to September 25, 1985.

Settlor was survived by his wife, Spouse, and two sons, A and B. Spouse and A are currently living. A currently has three children, Grandchild 1, Grandchild 2, and Grandchild 3. B died on Date 4, survived by a child, Child, who is purported to be B's biological daughter. Child was born out of wedlock on Date 5 to her mother, Y.

Pursuant to Part 1.9 and Section 2 of Trust, upon the death of Settlor, Trust was divided into two separate trusts known as the Marital Trust and the Family Trust. The current trustees of Trust, including the Family Trust and the Marital Trust, are Spouse, Individual, and Bank. Trust is governed by the laws of State.

Part 2.2 provides that Spouse is to receive the entire net income of the Marital Trust at least quarter-annually during her lifetime. Pursuant to Part 2.3, distributions of principal from the Marital Trust may be made to Spouse in the sole discretion of the trustees other than Spouse (Other Trustees) to permit Spouse to maintain Spouse's standard of living or to relieve any condition of emergency, hardship or special need. The Other Trustees may invade the principal of the Family Trust if they determine that a distribution to Spouse from the Marital Trust would be impracticable. Part 2.4 provides that upon the death of Spouse, the entire remaining principal of the Marital Trust is to be distributed to or in favor of such persons, including the estate of Spouse, in such manner and in such proportions, in trust or otherwise, as Spouse may appoint by specific reference to this power in her will. Any unappointed portion of the principal of

the Marital Trust is to be divided and distributed to, or held in trust for the benefit of the beneficiaries of Family Trust.

Part 2.25 provides that during Spouse's life, payments of income and/or principal from the Family Trust are to be made to Settlor's grandmother, Settlor's mother-in-law, and Settlor's sister, and the balance of income, if any, to Spouse at least quarter-annually. Settlor's grandmother, Settlor's mother-in-law, and Settlor's sister are deceased. Accordingly, Spouse currently receives the net income quarter-annually from the Family Trust. Upon the death of Spouse, the trustees are to hold or distribute the entire remaining principal of the Family Trust (including any amounts distributable to them by reason of Spouse's will and any unappointed portion of the Marital Trust), as follows: The trustees are to pay a charity and named individuals amounts as specified in Part 2.5.1. The remainder is to be divided per stirpes into separate shares for Settlor's issue living on Spouse's date of death. Each share for a child of Settlor is held in a Primary Trust. Each share for issue of Settlor who is not a child of Settlor is held in a Secondary Trust. The beneficiary for whom each trust is created is called the Primary Beneficiary of his or her respective trust.

Until termination of a Primary Trust, the trustees are to pay the net income in convenient installments to the Primary Beneficiary. Payments of principal may be made to the primary beneficiary at the uncontrolled discretion of the trustees in the event of a condition of hardship, emergency or special need. Upon a Primary Beneficiary's death, income may be distributed to the Primary Beneficiary's surviving spouse and issue. Each Primary Trust is to terminate upon the death of the survivor of the Primary Beneficiary, Settlor's grandmother, Settlor's mother-in-law, and Settlor's sister. Upon termination, the trustees are to deliver the principal to a class composed of the Primary Beneficiary's surviving spouse and issue as appointed in the Primary Beneficiary's will. Any unappointed portion is to be delivered per stirpes to the issue of the Primary Beneficiary who survive the Primary Beneficiary. If there are none, then the trust estate is to be delivered to the issue of the Settlor, per stirpes.

Until termination of a Secondary Trust, the trustees are to pay the net income to the Primary Beneficiary. When a Primary Beneficiary reaches age 21, the trustees are to distribute one-third of the Secondary Trust principal to the Primary Beneficiary. At age 25, the trustees are to distribute one-half of the Secondary Trust principal to the Primary Beneficiary. At age 30, the trustees are to distribute the principal of the Secondary Trust to the Primary Beneficiary. Each Secondary Trust is to terminate upon the death of the Primary Beneficiary. Upon termination, the trustees are to deliver the corpus to a class composed of the Primary Beneficiary's surviving spouse and issue as appointed in the Primary Beneficiary's will. Any unappointed portion is to be delivered per stirpes to the issue of the Primary Beneficiary who survive the Primary Beneficiary. If there are none, then the trust estate is to be delivered to the issue of the Settlor, per stirpes.

Part 2.6.1. of Trust provides that no trust created shall continue for longer than 21 years after the death of the last to die of a class composed of Settlor, Spouse, Settlor's children living on Date 1, Settlor's grandmother, Settlor's mother-in-law, and Settlor's sister.

It is represented that no amendments were made to Trust after September 25, 1985 and no additions have been made to either the Family Trust or Marital Trust since that date.

Part 3.1.9. provides that the trustees have the power, in dividing any property into shares or in distributing such shares, to divide or distribute in cash, in kind, or partly in cash and partly in kind, in such manner as the trustees believe proper, and for the purposes of division or distribution, to resolve all doubtful questions as to the value of property and to allocate assets among trusts or beneficiaries when an exact division or the distribution or allocation of undivided interests is not practicable or desirable.

State Law 1 defines "issue" as an individual's descendant. Part 4.6.2 of Trust provides that the term "issue," shall include any adopted child of Settlor, and any person legally adopted by any of Settlor's issue shall be deemed for purposes of the trust agreement to be the issue of his adopting parent, including, without limitation on the generality of the foregoing, for the purpose of determining (i) the adopted person is the issue or lineal descendant of any other person and (ii) the issue or lineal descendants of such adopted person are the issue or lineal descendants of any other persons.

A controversy exists between the parties as to whether the term "issue" includes Child, for purposes of determining the remainder beneficiaries of Trust. Under State law, where an interest vests at the time of the testator's death, the law at the testator's death applies, but the intention of the settlor is paramount in construing a document. See Citation 1. In cases where the interest is to take effect upon a later event, the law at such later time or event is applied. See Citation 2. Trust is silent as to the inclusion of Child as Settlor's descendant. The trustees assert that the remainder interests of Settlor's issue are all vested interests and that such interests vested upon Settlor's death.

Child was born in State and Trust is a State trust so State law applies to determine the legitimacy of Child. Under State law, a specific statutory test determines the legal acknowledgment of an illegitimate child. This statutory test, however, has changed over the years since Trust was established on Date 1. It remains unclear as to which test applies to determine the legitimacy of Child: the law in effect at the time of Settlor's execution of Trust, at the time of Settlor's death, at the time of the birth of Child, at the time of B's death, or at some future time (e.g., the death of beneficiaries with intervening life estates).

State law at the time of Trust's execution and at the time of Settlor's death, provided for paternity only through a signed and recorded acknowledgement by the man and joined by the mother. State Law 2. State Law 3, in effect at the time of Child's birth, provides that a man is considered the natural father of a child born out of wedlock for all purposes of intestate succession if any of the following occurs: (a) a signed and recorded acknowledgement by the man with the mother; (b) a written request for a correction of certificate of birth; or (c) the man and the child has a mutually acknowledged relationship of parent and child which began before the child became 18 and continued until terminated by the death of either. State Law 4, in effect at the time of B's death, provides for the same tests under State Law 3, but also adds that parentage for purposes of intestate succession may also be proven by an order of filiation entered by the court, or a probate court determination that the man is the child's father, using the standards and procedures established under the paternity act. State Law 5.

Child was born out of wedlock to Y. B and Child submitted to a DNA test which concluded that B was the biological father of Child. B acknowledged Child as his child and was involved in Child's life. Settlor's Spouse cares for Child as a grandmother as she does for her other grandchildren. B, however, was not listed on Child's birth certificate and while B joined with Y to complete an application for correction of a certificate of birth for Child, there is no evidence that the application was submitted for processing, nor was a substituted certificate of birth ever issued. B is purported to have signed an Affidavit of Parentage for Child (Affidavit), but such Affidavit was not dated, not notarized, and never filed or recorded as required under State Law 3. While B and Child may have borne a mutually acknowledged relationship of parent and child, as set forth under State Law 3, it has not been proven by the judicial process. B filed a Petition for Filiation in Year 2, but it was dismissed for lack of progress; therefore, no Order of Filiation was ever entered. B died on Date 4. Accordingly, the legal status of Child as B's child has not been resolved by a court of proper jurisdiction.

If Child is determined to be a "descendant" of Settlor, upon the death of Spouse, Child and A would each receive one-half of the remainder of Trust, per stirpes, as set forth in Section 2 of Trust. A's children, Grandchild 1, Grandchild 2, and Grandchild 3, would each receive a one-sixth share of the remainder after the death of Spouse and A. If Child is determined not to be a "descendant" of Settlor, she would receive no interest, A would receive the entire remainder for his life, and A's children, Grandchild 1, Grandchild 2, and Grandchild 3, would each receive a one-third remainder interest upon A's subsequent death.

Child, through her counsel, has considered the pursuit of litigation to obtain a binding judicially enforceable determination of her paternity. Because of the sensitive family concerns and Spouse's urging that all parties amicably resolve the disputed issues, the parties entered into settlement negotiations in Year 2. Each of the

interested parties is represented by legal counsel, including any unborn, unknown or unascertainable beneficiaries through their guardian ad litem. Several years later, on Date 6, the parties reached an agreement (Settlement Agreement) concerning the provisions of Trust.

Settlement Agreement provides that Child shall be recognized as the issue of Settlor and the issue of B for purposes of Trust. Specifically, Part 2.5.2. of Trust is modified as follows:

Descendants of Settlor are defined to include his son [A], the sons of [A]: [Grandchild 1], [Grandchild 2], and [Grandchild 3] (collectively "[A]'s children" and individually as [A]'s child), the daughter of [B]: [Child] (all four (4) grandchildren are collectively "grandchildren" and individually "grandchild"), and the descendants of Settlor's grandchildren; all others, if any are excluded.

The Settlement Agreement also provides that upon the death of Spouse, the balance of the Family Trust not specifically bequeathed to a named charity and certain individuals, shall be divided as follows:

1. If A and Child survive Spouse, the trustees shall allocate three-fourths of the remainder of the principal to the trust for A and one-fourth of the remainder of the principal to the trust for Child.
2. If A fails to survive Spouse and Child survives Spouse, the trustees shall divide the assets into a sufficient number of shares of equal value to provide one share for each of Settlor's grandchildren who then survive and one share for each of Settlor's grandchildren who has died leaving descendants then living; the shares shall be allocated to the trust for Child and to the trust for A's descendants, as the case may be.
3. If A survives and Child fails to survive Spouse, the trustees shall allocate three-fourths of the remainder of the principal to the trust for A and one-fourth of the remainder of the principal to the trust for Child, if any descendants of Child then survive; if none, the trustees shall allocate all of the remainder of the principal to the trust for A.
4. If neither A nor Child survive Spouse, the trustees shall divide the assets into a sufficient number of shares of equal value to provide one share for each of Settlor's grandchildren who then survive and one share for each of Settlor's grandchildren who has died leaving descendants then living; the shares shall be allocated to the trust for Child and to the trust for A's descendants, as the case may be.

Moreover, under the modifications of Trust, Settlor's grandchildren will each be entitled to one-third of his or her respective trust at age 25, one-half of the trust at age 30, and the balance of the trust at age 35. As to Child's trust, Child will receive

discretionary distributions of income based on a standard defined in the Settlement Agreement. Any undistributed income will be added to principal.

Trust will bear each of the parties' costs and attorneys fees through the time of the entry of order approving Settlement Agreement. It is represented that Settlement Agreement is the result of arm's length negotiations and is intended to avoid further conflicts among the beneficiaries of Trust.

On Date 7, State Court approved the Settlement Agreement and issued an Interlocutory Order (Order), pending the issuance of a favorable private letter ruling from the Internal Revenue Service. It is represented that an amended Settlement Agreement will be executed by the parties providing that each of Settlor's grandchildren will have a testamentary general power to appoint the principal of his or her respective trust.

You have asked for the following rulings:

1. The (i) recognition and treatment of Child as lawful issue of Settlor for purposes of Trust and Order; (ii) the exchange of mutual general releases; (iii) the trustees' use of trust funds, from income and principal, to pay and reimburse or advance the parties for reasonable and necessary attorneys' fees and related expenses incurred and paid to effect the Settlement Agreement; and (iv) the modified provisions of trust (together the Proposed Modification), will not cause Trust or Family Trust to be subject to the generation-skipping transfer (GST) tax under § 2601 and Family Trust will continue to be exempt from GST tax.

2. The Proposed Modification will not be deemed to result in additions or constructive additions to Trust.

3. The Proposed Modification will not give rise to a gift under § 2501 by the parties to the Settlement Agreement.

Rulings 1 and 2

Section 2601 of the Internal Revenue Code imposes a tax on every generation-skipping transfer (GST) made after October 26, 1986. Section 2611(a) defines the term "generation-skipping transfer" as (1) a taxable distribution, (2) a taxable termination, and (3) a direct skip.

Under § 1433(a) of the Tax Reform Act of 1986 (Act) and § 26.2601-1(a) of the Generation-Skipping Transfer Tax Regulations, the GST tax is generally applicable to generation-skipping transfers made after October 22, 1986. However, under § 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i), the tax does not apply to a transfer under a trust (as defined in § 2652(b)) that was irrevocable on September 25, 1985, but only to the extent that such transfer is not made out of corpus added to the trust after

September 25, 1985 (or out of income attributable to corpus so added).

Section 26.2601-1(b)(4) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the GST tax under § 26.2601-1(b)(1), (b)(2), or (b)(3) will not cause the trust to lose its exempt status. The rules of § 26.2601-1(b)(4) are applicable only for purposes of determining whether an exempt trust retains its exempt status for GST tax purposes. They do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of capital gain for purposes of § 1001.

Section 26.2601-1(b)(4)(i)(B) provides that a court-approved settlement of a bona fide issue regarding the administration of a trust or the construction of terms of the governing instrument will not cause an exempt trust to be subject to the provisions of chapter 13, if -- (1) The settlement is the product of arm's length negotiations; and (2) The settlement is within the range of reasonable outcomes under the governing instrument and applicable state law addressing the issues resolved by the settlement. A settlement that results in a compromise between the positions of the litigating parties and reflects the parties' assessments of the relative strengths of their positions is a settlement that is within the range of reasonable outcomes.

Section 26.2601-1(b)(4)(i)(D) provides that a modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy § 26.2601-1(b)(4)(i)(A), (B), or (C) of this subsection) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, but only if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in § 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust.

Trust was created and irrevocable before September 25, 1985. It is represented that no additions, constructive or actual, have been made to Trust after that date. Consequently, Trust is currently exempt from GST tax.

In this case, each party was represented by legal counsel. The prospective beneficiaries had distinct and adverse economic and administrative interests. Some of the parties wanted to pursue litigation to resolve the issues. Settlement negotiations were carried out over several years until Settlement Agreement was reached. The parties have obtained Court approval of Settlement Agreement pending the issuance of this private letter ruling.

We conclude that Settlement Agreement constitutes a settlement of bona fide issues regarding the administration of Trust or the construction of the terms of Trust. We also conclude that the terms of Settlement Agreement are the product of arm's length negotiations and represent a compromise that reflects the parties' assessments of the relative strengths of the positions of the family lines of A and B. Further, the terms of Settlement Agreement are within the range of reasonable outcomes under the governing instrument and the applicable State law addressing the issues resolved by Settlement Agreement.

In the instant case, the modification of Trust provides that the trust principal of a trust for the benefit of Grandchild 1, Grandchild 2, Grandchild 3, or Child, that would otherwise pass down to his or her respective descendants by representation on termination prior to a primary beneficiary's receipt of the entire principal, will be subject to a testamentary general power to appoint the principal of his or her trust. Accordingly, the assets of a trust for the benefit of Grandchild 1, Grandchild 2, Grandchild 3, or Child will be included in the respective primary beneficiary's gross estate for estate tax purposes under § 2041(a)(2). Further, Grandchild 1, Grandchild 2, Grandchild 3, and Child will each be treated as the transferor of the trust principal for GST tax purposes under § 2652(a)(1).

Accordingly, based on the facts submitted and the representations made, we rule as follows:

1. The (i) recognition and treatment of Child as lawful issue of Settlor for purposes of Trust and Order; (ii) the exchange of mutual general releases; (iii) the trustees' use of trust funds, from income and principal, to pay and reimburse or advance the parties for reasonable and necessary attorneys' fees and related expenses incurred and paid to effect the Settlement Agreement; and (iv) the modified provisions of trust (together the Proposed Modification), will not cause Trust or Family Trust to be subject to the generation-skipping transfer (GST) tax under § 2601 and Family Trust will continue to be exempt from GST tax.

2. The Proposed Modification described in the Settlement Agreement, as amended, will not be deemed to result in additions or constructive additions to Trust.

Ruling 3

Section 2501 imposes a tax for each calendar year on the transfer of property by gift during such calendar year by any individual. Section 2511 provides that the tax imposed by § 2501 applies whether the transfer is in trust or otherwise, direct or indirect, and whether the property transferred is real or personal, tangible or intangible.

Section 25.2511-1(b) of the Gift Tax Regulations provides that, as to any property, or part thereof or interest therein, of which the donor has so parted with

dominion and control as to leave in him or her no power to change its disposition, whether for his or her own benefit or for the benefit of another, the gift is complete. But, if upon a transfer, a donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the facts in the particular case.

Section 25.2511-1(c)(1) provides that any transaction in which an interest in property is gratuitously passed or conferred upon another, regardless of the means or device employed, constitutes a gift subject to tax.

Whether an agreement settling a dispute is effective for gift tax purposes depends on whether the settlement is based on a valid enforceable claim asserted by the parties and, to the extent feasible, produces an economically fair result. See Ahmanson Foundation v. United States, 674 F.2d 761, 774-775 (9th Cir. 1981). Thus, state law must be examined to ascertain the legitimacy of each party's claim. A settlement that fairly reflects the relative merits and economic values of the various claims asserted by the parties and reaches a settlement that is within a range of reasonable settlements will not result in a transfer for gift tax purposes.

As discussed above, Settlement Agreement represents the resolution of a bona fide controversy between the family lines of A and B. All interested parties who hold or may hold an interest in Trust, including any minors, and any unborn, unknown or unascertained heirs, have been represented in the proceedings that culminated in the Date 7 Court Order approving Settlement Agreement. Further, based on the facts as presented, the terms of Settlement Agreement are the product of arm's length negotiations among all the interested parties. We conclude that Settlement Agreement, as amended to grant each of Settlor's grandchildren a testamentary general power to appoint his or her respective trust property, reflects the rights of the parties under the applicable law of State that would be applied by the highest court of State. Accordingly, based on the facts submitted and representations made, we rule that implementation of Settlement Agreement, as amended, will not result in a gift under § 2501 by the parties to the Settlement Agreement.

Further, under the circumstances, Grandchild 1, Grandchild 2, Grandchild 3, and Child will not be treated as making a gift for purposes of § 2501 if on termination of a primary beneficiary's trust, the primary beneficiary holds a testamentary general power to appoint trust property from his or her respective trust.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

James F. Hogan
Chief, Branch 4
Office of Associate Chief Counsel
(Passthroughs and Special Industries)

Enclosures (2)